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CONGRESSIONAL OVERSIGHT PANEL

# Opening Statement of J. Mark McWatters

## Congressional Oversight Panel Hearing on the TARP and Executive Compensation Restrictions

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Thank you Senator and welcome to the Panel.

Over the past two years members of Congress, policy wonks, academics and private sector participants have debated the existence of any linkage between the compensation structures employed by TARP recipients and other institutions and the financial contagion that erupted in the last quarter of 2008.

Some commentators contend that a cause and effect relationship exists between the structure of an employee's compensation package and the amount of risk the employee is willing to undertake on behalf of his or her employer, and that some compensation packages may directly encourage employees to undertake high risk investment strategies and business ventures. Followers of this school argue that both senior executives and junior employees will promptly respond to any financial incentives offered by their employers and modify their behavior so as to maximize their aggregate compensation. I refer to this as the "Show Me the Money Theory."

Under this theory, some mortgage lenders, for example, may have originated residential mortgage loans without having conducted prudent due diligence investigations of their borrowers. Likewise, some TARP recipients and other institutions may have packaged mortgage loans in securitization vehicles without having properly vetted the underlying collateral and sold the securitized tranches to investors who themselves may have elected to forgo any meaningful investigation of the legal and financial integrity of the transactions. The mortgage originators and securitization sponsors may have neglected their respective due diligence undertakings because they were in effect compensated *merely to close* mortgage loans and securitizations and to *pass the risks* associated with the investments downstream to the purchasers of the securitized tranches, regardless of the intermediate to long-term financial soundness of the underlying mortgages and securitized tranches. The end-user investors may have elected to forgo their independent investigations of the mortgage loans and securitized tranches in reliance upon the opinions of ratings agencies, legal counsel, accountants and other third-party advisors and experts. Some of these professionals may also have been financially motivated to facilitate the premature closing of the securitization transactions because the payment of their fees was often—at least in part—dependent upon a prompt and successful closing. Thus, under the Show

Me the Money Theory, the parties to a securitization transaction may have invested significant effort in ascertaining that each transaction closely paralleled the "form" of a text-book securitization transaction—with all the "i's" dotted and "t's" crossed—while allocating relatively less attention to the "substance" of the transactions and the intermediate to long-term prospects for the timely repayment of the securitized tranches.

Other commentators, however, reject the Show Me the Money Theory and argue that the financial crisis of 2008 and beyond was not spawned by misdirected compensation policies, but, instead, arose from the failure of mortgage originators and securitization sponsors and investors to appreciate the magnitude of the risks inherent in mortgage lending and the pooling of loans into opaque securitization products. Followers of this school contend that—notwithstanding a few bad apples—mortgage loan originators and securitization sponsors and investors were not specifically motivated to forsake any of their legal or ethical duties and responsibilities based upon the structure of the compensation programs offered by their employers. To the contrary, these officers and employees—so the theory goes—undertook thorough and proper due diligence investigations of the collateral underlying each securitization transaction and, prior to making any investment decision, relied upon sophisticated stress tests and other econometric models; geographic and income diversification protocols; prepayment, default and collection metrics grounded in reasonable historic norms; and took great comfort in knowing that a material nationwide recession in residential real property had not occurred in approximately 80 years. I refer to this as the "White Heart, Empty Head Theory."

Under this theory, directors, officers and employees of TARP recipients and other institutions[1]—from the perspective of pure self-interest—would not have knowingly taken any action that could have resulted in the loss of their employment, the material devaluation of their incentive stock options and grants, or the bankruptcy, takeover or liquidation of their firms. That is, these individuals possessed no desire for self-immolation and they discharged their duties accordingly.[2] A few years ago it was all but conventional wisdom that the mortgage loan securitization process represented modern day alchemy where brilliant investment bankers mysteriously transformed billions of dollars of illiquid, risky mortgage loans into readily marketable, investment grade securitized instruments. Many of the alchemists—notwithstanding their business acumen and enviable track records—were dead wrong with respect to the mortgage loan securitization implosion, yet, if the White Heart, Empty Head Theory prevails, they were not motivated in any manner to game the system based upon the structure of their employer's compensation program.

[1] These other institutions include commercial banks, investment banks, hedge funds, private equity firms, sovereign wealth funds, endowments and pension plans.

[2] Most investment professionals—understandably—take occasional comfort in following the "herd" and few truly relish outlier status. As such, the handful of senior managers and investment advisors who accurately foresaw the brewing financial crisis would have faced—and in fact did face—incredible peer and market pressure to "get with the program" and adhere to the seemingly well vetted conventional norms of the day.

As in other instances, the solution to our vexing inquiry may not reside solely within the domain of either theory or even a hybrid of the two. Although the White Heart, Empty Head Theory has a certain visceral appeal and it is significant to note that relatively few investment professionals accurately foresaw the impending financial tsunami, those who dismiss the Show Me the Money Theory may be disappointed as we discover more about how the sausage was actually made in the residential mortgage securitization factories. To the extent it is ultimately determined that the White Heart, Empty-Head Theory presents the more compelling view, we should remain cautious so as not to misallocate effort and expense to the structuring of compensation programs directed at addressing the putative harm presented by the Show Me the Money Theory. In the final analysis, I suspect that both theories may help explain the genesis of the recent financial crisis. The compensation packages offered by some TARP recipients most likely encouraged a certain amount of excessive and unnecessary risk taking, the consequences of which, unfortunately, were not fully appreciated by the TARP recipients themselves, their federal and state regulators or the capital markets.

The most challenging work remains, however, as we continue to struggle with the fundamental issue: How does a too-big-to-fail TARP recipient employer structure a compensation program so as to identify and minimize in a timely manner unnecessary and excessive risk-taking while encouraging senior executives and other managers to assume sufficient risk so as to assure the long-term profitability of the employer?

Regardless of which theory prevails, regulators should remain mindful that ill-conceived efforts to deter certain behavior may have unintended consequences and cast a chilling effect throughout the financial services community and capital markets.[3] For example, the recently enacted Dodd-Frank Act requires certain employers to disclose the ratio of the median annual total compensation of a company's employees (excluding its chief executive officer (CEO)) to the total annual compensation of its CEO, a requirement that could have the unintended consequence of encouraging the outsourcing of lower wage jobs.[4]

I hope that we are able to explore these two theories and the executive compensation provisions of the Dodd-Frank Act today.

Thank you and I look forward to our discussion.

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[3] Although, understandably, some may feel envy towards those senior executives who receive substantial compensation packages, it remains problematic that such emotions alone should serve as the basis for sound public policy initiatives.

[4] Internal Revenue Code Section 162(m) as originally enacted provides that annual compensation – other than performance-based compensation – over $1 million is not deductible if paid to certain key employees of a publicly-traded corporation. Although section 162(m) was arguably enacted so as to reduce aggregate executive compensation, it may have had the opposite effect by encouraging employers to grant significant performance-based compensation awards to their key employees.